

**Testimony Of  
Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities**

**Before the  
Maryland Senate Budget and Taxation Committee**

**Hearing on S.B. 576, Combined Reporting  
March 7, 2023**

Chair Guzzone, Vice Chair Rosapepe, and Members of the Budget and Taxation Committee, I am Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. The Center is a non-partisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality in fiscally responsible, equitable, and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people to help inform debates and achieve better policy outcomes. I appreciate the opportunity to submit testimony in support of S.B. 576, Senator Young’s and Senator Rosapepe’s bill to mandate the use of combined reporting for the corporate income tax.

**Combined Reporting Is Needed to Nullify Forms of Corporate Tax Sheltering to Which Maryland Remains Vulnerable**

Combined reporting remains an essential tax policy reform for Maryland if it is to have a fair and robust corporate income tax. Year in and year out, the state suffers significant erosion of its corporate tax base because of corporate tax avoidance techniques that exploit the absence of combined reporting. Several of these strategies cannot be stopped at all — or in a sufficiently cost-effective manner for doing so to be realistic — through any policy reform other than combined reporting.

Let me give you one example, which goes by the name of “entity isolation.” That tax minimization strategy is used when, for example, an out-of-state manufacturer with Maryland sales needs to have some physical presence in Maryland (for example, to train its customers’ employees how to use its products), but the manufacturing itself is done outside the state. The corporation forms a separate subsidiary to employ the people that must enter Maryland, but the profit on the sale in Maryland of the manufactured items themselves remains locked in the out-of-state manufacturing arm that Maryland cannot tax because of a federal law that bars the state from taxing companies that only solicit sales here (Public Law 86-272). Entity isolation is Corporate Tax Avoidance 101, it is perfectly legal, and it prevents Maryland from taxing profits that are earned through sales to Maryland customers. Maryland enormously increased the incentive for out-of-state

manufacturers to shelter their income in this way when it enacted a single sales factor apportionment formula for them two decades ago.

We know that entity isolation is a widespread corporate tax shelter that is likely costing Maryland substantial revenues thanks to the data that the state compiled for several years from hypothetical (or “pro-forma”) combined reporting returns mandated by 2007 legislation. Those data showed that the so-called “Finnigan” version of combined reporting would have raised substantially more revenue for the state than would the alternative, so-called “Joyce” approach. The Finnigan version of combined reporting embodied in S.B. 576 nullifies entity isolation, while the Joyce approach does so only partially.

Another example of a tax minimization strategy to which Maryland remains vulnerable because it does not require combined reporting is just plain-vanilla intercompany transfer pricing. That involves one member of a corporate group located in a lower-tax state charging a corporate subsidiary doing business in Maryland an artificially high price for inventory for resale or for production inputs for a product or service for sale to Maryland customers. In the past couple of years, I was hired to be an expert witness in two cases involving another non-combined-reporting state’s efforts to nullify this tax avoidance strategy, which is being exploited by two household name big box retailers that have stores in Maryland as well. In the one case that went to trial, the transfer prices for inventory, marketing, management, and other services are being set so high that the in-state stores were reporting losses even though the retail chain is highly profitable on a national basis. The state faces an uphill battle in challenging those prices, a battle it wouldn’t have to be fighting had state lawmakers there mandated combined reporting.

### **Combined Reporting Will Help Level the Playing Field – Especially for Small Corporations**

Not many small businesses have the resources or sophistication to set up and operate the kinds of tax avoidance strategies just described that require multistate operations and the formation of subsidiaries in low- or no-tax states. But small corporations often compete with large corporations that can do this. Large corporations that are willing and able to engage in this kind of aggressive tax avoidance may be able to attract capital at a lower cost than their in-state competitors or use their tax savings to undercut the prices of smaller corporations. By nullifying many forms of tax avoidance, combined reporting can thus help smaller, locally based corporations compete on a more level playing field and thereby preserve more local jobs.

Furthermore, by no means do even all large corporations engage in aggressive income-shifting strategies. They may not be well-positioned to do so because, for example, they do not own significant valuable intangible assets, or because they are service businesses that are not covered by Public Law 86-272 and cannot easily engage in “entity isolation.” Or it may simply be the case that the company’s culture does not prioritize aggressive tax avoidance. Regardless, states simply should not maintain a tax structure that gives unfair advantage to those companies most willing and able to push the envelope, but that is precisely what not requiring combined reporting does.

Opponents of combined reporting here often point to the fact that its enactment will create “winners and losers,” that is, that some corporations will actually pay less tax under combined reporting than they do under the current, “separate filing” system. That is indeed true. The most common reason for that result is that corporations that have some subsidiaries with true, economic losses can use those losses to offset the profits of other subsidiaries immediately, rather than having

to carry them forward and deduct them in future years. Many significant changes in tax policy and tax law create winners and losers, and I have never understood why combined reporting opponents think that the fact that some corporations will pay less is a compelling argument against the change. To the contrary, it shows that this is a neutral tax policy change and not the “money grab” that opponents make it out to be.

### **Not Requiring Combined Reporting Is Inconsistent with States’ Use of Formula Apportionment to Tax Multistate Corporations**

Tax avoidance aside, not requiring combined reporting is fundamentally inconsistent with the way states tax multistate corporations. As you know, states do not seek to measure the profits realized on the sale of specific items within their borders. This would require the tracking of the receipts from the in-state sale of specific products and the specific expenses incurred in supplying those goods and services. Not only would that be an administrative nightmare for companies to comply with and for states to audit, it would also be fraught with conflict because there is no objective way to assign to a specific state the overhead expenses that are shared among all production locations or the savings in expenses arising from economies of scale. That is why states use a formula to assign to themselves a reasonable share of the nationwide profit of a multistate corporation. But not requiring combined reporting is conceptually inconsistent with formula apportionment. As soon as a state recognizes for tax purposes the profit reported by geographically isolated entities merely because they are separately incorporated, it has nullified what it was trying to achieve through the use of formula apportionment.

As it did decades earlier with respect to formula apportionment, the U.S. Supreme Court has twice upheld the constitutionality of combined reporting as a reasonable and fair means of determining the share of a multistate corporation’s income a state may tax. The same cannot be said of some of the other approaches to preventing abusive interstate income-shifting that are sometimes put forward as alternatives to combined reporting – such as the intangible addback law that Maryland has adopted.

### **A Growing Number of States Are Recognizing the Benefits of Combined Reporting**

Whether or not to require combined reporting is a key policy choice that is relevant to the tax systems of 45 states plus the District of Columbia (all states except Nevada, Ohio, South Dakota, Washington, and Wyoming). More than three-fifths of those jurisdictions — 28 plus DC — have recognized the compelling case for combined reporting and now require it. Twelve states and DC have enacted combined reporting in the last 15 years — a rapid rate of adoption for such a significant change in state tax policy. Combined reporting has long been required and non-controversial in many generally Republican-controlled states, including Alaska, Arizona, Utah, Idaho, Montana, Kansas, and Nebraska. It was a Republican Governor, Jim Douglas, who started the post-2004 wave of combined reporting adoption with his (fulfilled) recommendation that Vermont switch. Combined reporting was enacted under Republican Governor Matt Bevin and a Republican-controlled Kentucky legislature in 2018. And, of course, our neighbor West Virginia is a combined reporting state as well.

## Combined Reporting and State Economic Growth

Over the many years that the adoption of combined reporting has been considered in Maryland, members of this committee have undoubtedly heard claims that it would discourage corporations from investing in the state in the future and perhaps even cause corporations already here to leave. These claims should be given little credence. Between 2008 and 2010, I conducted research in four states to document all the states in which the largest private sector employers in those states maintained physical facilities, unquestionably subjecting them to those states' corporate income taxes. The most recent study I did looked at Maryland's largest 120 largest corporations (as measured by their Maryland employment). I found that a large majority of those companies quite willingly subjected themselves to combined reporting in other states:

- At least 108 of the 120 largest Maryland employers maintained facilities in at least one combined reporting state or were members of a corporate group that had a facility in at least one combined reporting state. The “compliance burdens” and additional tax liability arising from combined reporting could not be that unreasonable if these companies — or the parent corporation that controls their decision-making — willingly maintained a facility in one or more combined reporting states.
- A large majority of the corporations I examined maintained facilities in multiple combined reporting states. Three-fourths of them — 90 out of 120 — had facilities in five or more combined reporting states. More than half — 67 out of 120 — had facilities in ten or more such states, and more than one-fourth — 34 out of 120 — had facilities in 20 or more combined reporting states.
- Eighteen companies had facilities in all 23 states that mandated combined reporting at that time.
- Ninety-three had a facility in California, the state that pioneered combined reporting and — as any corporate tax manager will attest — enforces it most aggressively.
- Thirty-two of the companies maintained their headquarters in combined reporting states.

I found comparable results in my Iowa, North Carolina, and New Mexico studies, as did two other organizations that conducted similar research in Connecticut and Wisconsin.

If corporations willingly subjected themselves to combined reporting in other states year-in and year-out, there simply is no reason to believe that they would shun Maryland as a place to invest were it to adopt combined reporting.

I have also looked at the record of combined reporting states in retaining manufacturing jobs. This may be a reasonable indicator of whether combined reporting has a negative impact on the attractiveness of a state for investment, since manufacturers in theory do not need to be as close to their customers as retailers, construction contractors, and other types of service businesses need to be and therefore can choose to locate where state and local tax policies are more to their liking. These data show that combined reporting states do no worse in manufacturing job retention and growth than separate filing states do. (I excluded from this analysis those states that do not levy a corporate income tax at all.)

Four of the five states with the highest rate of manufacturing job growth over the 10 years prior to the pandemic required combined reporting throughout the period, as did the state with the highest rate of manufacturing job growth — Michigan. Twenty-one states with corporate income taxes experienced at least 10 percent manufacturing job growth over those 10 years. Eleven of the 21 had combined reporting in effect throughout the period, and a twelfth state had enacted but not yet implemented it. Thirty-six states had net positive manufacturing job growth over the 10 years; 19 of them had combined reporting in effect throughout. In short, there is no obvious correlation between a state’s adoption of combined reporting and its relative success in attracting or retaining the most potentially footloose firms and their jobs.

Nor does academic research demonstrate that combined reporting has an adverse impact on state economic performance. For example, a 2007 study concluded that “there is no evidence that these [combined reporting] requirements diminish economic activity in states.” A 2012 study actually found that “States with more aggressive corporate income taxes, specifically those that include combined reporting requirements, tend to have higher entrepreneurship rates.” A 2014 study concluded that “Combined reporting has no discernable effect on personal income, G[rross]S[tate]P[roduct], or employment after controlling for tax rates, apportionment, and throwback rules.” A 2016 study found that “Other tax policy measures (the throwback rule, required combined reporting, the personal income tax, and corporate license fees) are typically statistically insignificant” in affecting corporate investment in states. As with many subjects, studies can be found on both sides of the question; a 2003 study found that “The effect of the income tax burden on [corporate investments in] property is more pronounced for states mandating [combined] unitary taxation.” It should be noted, however, that the latter analysis only covered a period up to 1996 and misclassified three combined reporting states as having not adopted the policy.

There is a good explanation for why combined reporting does not appear to have a significant impact on state economic and job growth one way or the other. All state and local taxes paid by corporations represent on the order of 2-4 percent of their total expenses, on average. State corporate income tax generally represent less than 10 percent of that already small share. And most states that have prepared estimates predict that requiring combined reporting will boost corporate tax collections between 10 and 20 percent. It therefore should not be surprising that the evidence just cited suggests that combined reporting has not been a disincentive for corporations to continue investing and creating jobs in states that adopt it.

### **Combined Reporting and Corporate Income Tax Revenue Volatility**

Combined reporting opponents also claim its adoption would increase the year-to-year variability of corporate tax receipts so much as to make its adoption inadvisable. This claim rests on the fact that in some of the five years from 2006 to 2010 during which Maryland had in effect a requirement that corporations file hypothetical, or “pro-forma” tax returns using combined reporting, corporate income tax receipts under combined reporting would have been lower than they were under the existing “separate filing system. Viewed in the larger context, however, this fact does not diminish the case for combined reporting to any meaningful extent:

- The reduction in revenues was quite modest and occurred in only two of the five years under the “Finnigan” method of combined reporting, which is the method embodied in S.B. 576.

In tax year 2008, having the Finnigan method in effect would have reduced corporate tax revenues by only \$15.4 million, or 1.9 percent. In 2009, it would have reduced corporate tax revenues by \$56.1 million, or 6.5 percent. Moreover, even with that larger impact in 2009, corporate tax revenues would still have risen between tax year 2008 and 2009 by \$26.4 million, or 3.4 percent.

- These reductions are of the same order of magnitude as normal year-to-year fluctuations in corporate tax receipts. For example, corporate tax receipts fell 2.4 percent between tax year 2005 and 2006 and 9.0 percent between tax year 2009 and 2010. No one could reasonably argue that fluctuations of such magnitude would justify repealing the corporate income tax, so it is disingenuous of combined reporting proponents to argue that fluctuations of similar magnitude attributable to combined reporting justify forgoing this valuable reform — all the more so when one notes that it would have boosted corporate tax receipts by fully 27 percent in tax year 2006 and 20 percent in tax year 2007.
- The years during which pro-forma combined filing was in effect were not normal years. The Great Recession that began in December 2007 and ended in June 2009 was the deepest U.S. economic downturn since the Great Depression. Drawing any conclusions regarding the inevitable impact of combined reporting on Maryland corporate tax receipts during recessions based on these particular years is problematic.
- During the Great Recession, national personal income fell 5.2 percent from the second quarter of 2008 to the first quarter of 2009, while Maryland personal income fell only 3.0 percent during that period. Based on that experience, combined reporting opponents imply that corporations taxable in Maryland are inevitably going to be substantially more profitable than their out-of-state affiliates during recessions because the Maryland economy is substantially shielded from downturns by the presence of federal government activities. They argue that with combined reporting Maryland's corporate income tax will be "importing the losses" of those out-of-state affiliates, leading to reduced revenue. But, again, the Great Recession was atypical. During the 2001 recession, there was very little difference in the growth rates of the U.S. and the Maryland economies. National personal income declined by only 0.1 percent from its highest to lowest point, while it increased by just 0.3 percent in Maryland during the same period.

Many revenue sources, such as capital gains realized by high-income people, are also quite volatile and frequently drop significantly during recessions. No one suggests that the appropriate response to this volatility is to forgo the revenue and sacrifice the improvement in tax fairness that including the revenue source in the tax system creates. The appropriate solution is for the state to have an adequate rainy-day fund with which to weather recessions and to build into state budgets only the average annual yield of the revenue source rather than the amount it generates in peak years. That is the appropriate strategy with which to address the underlying inherent volatility of state corporate taxes and any modest increase in that volatility that the adoption of combined reporting might lead to. Given the state's needs for critical investments in education, health care, and other services, it makes no sense to forgo an annual revenue yield in excess of \$200 million because of the possibility of a slight increase in corporate income tax volatility.

## **The Alleged “Complexity” of Combined Reporting**

Corporate opponents of combined reporting also object that combined reporting is complex and burdensome to comply with, particularly because of the subjectivity entailed in determining which subsidiaries of a multi-corporate group are and are not engaged in a so-called “unitary business” with the parent and/or subsidiaries subject to corporate income tax in a state. Such a claim compares combined reporting to the current system under which the state is largely powerless to stop many forms of interstate income shifting. If the state actually had the resources and attempted to adjust the prices that one member of a corporate group located in Maryland charged and/or paid other out-of-state members for intra-corporate sales of goods and services to prevent such shifting, then the subjectivity, litigation, and compliance burden flowing from such an effort would exceed that of combined reporting many times over.

Corporations already file consolidated tax returns for federal tax purposes and consolidated financial statements for financial reporting purposes; they know how to do the accounting. The only potential complexity that arises from combined reporting is determining which corporations are and are not part of the unitary group. As discussed previously, most major corporations are filing combined reporting-based tax returns in numerous states, so they appear to be figuring out how to do that. That said, Maryland could consider emulating Massachusetts and several other states by allowing corporations to make a long-term election to determine the combined group strictly based on common ownership with no subjective determination of whether a particular subsidiary is part of a “unitary business.” Such an election eliminates any argument that combined reporting imposes a significant or unreasonable compliance burden on corporations. (It must be offered as an election because the courts have held that combined reporting can only be mandated when the related corporations are economically integrated or “unitary.”)

Regarding the issue of state enforcement burdens, it is only necessary to observe that small population states with small revenue department staffs — states like Alaska, Idaho, Montana, New Hampshire, and Maine — have managed to successfully administer combined reporting-based corporate income tax structures for decades.

Finally, opponents of combined reporting sometimes argue that combined reporting will be burdensome and should not be enacted in a state because other combined reporting states have divergent laws concerning which kinds of corporate subsidiaries are included in the combined group and other fine points of the policy. This is a red herring and a disingenuous argument. Maryland cannot be responsible for divergent policy choices that other states have made nor should it reject an otherwise sound tax policy change because of those choices. The multistate corporate tax community is free at any time to encourage combined reporting states to harmonize their combined reporting laws to reduce business compliance burdens.

## **The Bill Should Be Amended to Drop the New Deduction for “Deferred Tax Liability”**

There is one provision of this bill which I respectfully urge the Committee to remove by amendment before approving it. It would enact a new corporate income tax deduction that would eventually cause the state to forgo a significant portion of the additional revenue that would be raised by this bill. The deduction is intended to offset a purely paper “expense” incurred by some large corporations when the state adopts combined reporting. The corporate proponents of this new deduction claim that without it, their stockholders will unfairly suffer a “double impact” from

the change. The first impact is the actual increase in Maryland income tax liability an affected corporation will experience when their tax-avoidance strategies are nullified. The second impact is an alleged drop in the corporation's stock value caused by an increase in the "deferred tax liability" reported on the corporation's financial statements. Proponents seek the new deduction to offset the alleged stock market effect — yet they have provided no evidence that the effect will actually occur. Such evidence should be readily available if the claim were true, given that a dozen states have adopted combined reporting in the past 20 years.

I have written an entire report on this proposed deduction, titled "States Should Reject Corporate Demands for "Deferred Tax" Deductions" (May 2019). It is available on the Center's website. The following are the main reasons why its enactment is completely unjustified:

- The proposed deduction is a narrow, special-interest tax break that only a handful of states have approved.
- The rationale for the deduction — that increased tax expenses reported on a corporation's financial statements would adversely affect a corporation's stock values — is implausible.
- Proponents of "deferred tax relief" have yet to provide any empirical evidence of a negative effect on stock prices.
- Congress does not include "deferred tax relief" in federal tax legislation with the same kinds of impacts on reported financial statement profits.
- Governments don't compensate corporations for the negative financial statement impacts of other changes in public policy.

Again, I respectfully urge the Committee to amend this provision out of the bill.

### **Adoption of Combined Reporting Is Long Overdue**

The enactment of combined reporting can make an important contribution to preserving Maryland's tax base from further erosion and ensuring that multistate and multinational corporations compete on a level playing field with their counterparts that do not seek to push the tax-avoidance envelope and with wholly in-state corporations. It will generate additional revenue with which to finance public investments in education, as confirmed by the fiscal note for this bill. Additional investment in education is critical to Maryland's economic future, and it will benefit Maryland businesses as well as Maryland families. Maryland's adoption of combined reporting is long overdue.

In conclusion, I respectfully urge the Committee to favorably report S.B. 576 with an amendment to remove the deduction for deferred taxes. I thank the Committee for the opportunity to submit written testimony. I may be reached at [mazerov@cbpp.org](mailto:mazerov@cbpp.org) if committee members have any questions.